No. 11467

IN THE
UNITED STATES
CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

SEATTLE BREWING & MALTING CO., a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

UPON PETITION TO REVIEW DECISION OF THE UNITED STATES TAX COURT

PETITIONER'S REPLY BRIEF

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INTRODUCTORY

Respondent, in his answering brief, has centered his argument principally on the question of whether the payments which petitioner became obligated to pay to Rainier periodically after July 1, 1940, pursuant to exercise of the option contained in the original contract of April 23, 1935, and which petitioner accrued in 1940 and 1941, having paid in 1941 the sum of $200,000, the amount of the first note, were deductible under the provisions of Section 23(a)(1), I.R.C. It is to be noted at the outset that the principal contention contained in respondent's brief does not deal

with as broad a question of law as that which was at issue before the Tax Court and which the Tax Court in its opinion dealt with at considerable length. This question involved whether or not, by exercise of the option, petitioner acquired from Rainier a capital asset, so that the payments which petitioner became obligated to make to Rainier after July 1, 1940, were the consideration and the purchase price therefor. The Tax Court found that a sale and transfer of a capital asset occurred. Petitioner has, of course, taken the view in its opening brief upon appeal that the Tax Court was in error in this respect and that petitioner obtained in return for its payments made after July 1, 1940, merely a limited license to use trade names which were and which remained the property of Rainier, in other words, a limited license basically unchanged in nature from that which it had enjoyed during the five preceding years. Once it is established that no sale of an asset occurred by reason of petitioner's exercise of the option or by events subsequent thereto, occurring within the taxable years in question, then it is petitioner's position that payments made pursuant to exercise of the option fall squarely within the purview of Section 23(a)(1), I.R.C. as "rentals, or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." Respondent has now apparently abandoned his former position, in which he asserted that a sale of a capital asset to petitioner had occurred and that the payments which petitioner made

were for "property to which the petitioner was taking or had taken title or in which it had an equity," and has repudiated the holding of the Tax Court insofar as it was based upon that legal position (Res. Br. 18, 19). Particularly noteworthy in this respect is respondent's statement beginning at the bottom of page 18 of his brief:

> "Taxpayer argues that there was no sale—that the agreement with Rainier constituted a license and the exercise by taxpayer of its option resulted merely in the substitution of lump sum payments in place of annual royalties based on a barrelage rate of production. *We are inclined to agree with this interpretation of the agreement.*" (Italics supplied)

In view of the above, petitioner in its reply brief will confine itself to a discussion of respondent's present position and will rely, without further amplification, upon the argument and authorities contained in its opening brief on the question of whether under the contract and exercise of the option a sale of a capital asset occurred which would characterize the payments made by petitioner after July 1, 1940, as being in payment of the purchase price for acquisition of such an asset and whether the Tax Court erred in its interpretation of the intent and legal effect of the contract between petitioner and Rainier. Thus it is apparent that the petitioner has succeeded in persuading the respondent as to the correctness of its position that both the annual royalties and the lump sum payments made by it pursuant to the exercise of its option were payments for a license and that such payments were properly termed royalties or rentals (Res. Br. 19).

ARGUMENT

With this background of departure from the main issue which was before the Tax Court, the respondent has devoted a major portion of his brief to the argument that even though the fixed or lump sum payments made by petitioner after July 1, 1940, were payments made for the use of another's property to which the taxpayer was not taking title, which, in effect, must result from his having conceded that there was no sale of a capital asset to petitioner and from his classification of the payments as rentals or royalties, such payments nevertheless are not deductible as business expenses for the taxable years involved here by reason of the fact that they were not geared to production and provided petitioner with benefits which extended beyond the year in which the particular payments were made or accrued.

To this argument, petitioner has a three-fold answer:

(1) The lump sum payments were just as much geared to production as the barrelage payments because they approximated the barrelage payments in amount;

(2) The lump sum payments were just as much measured by the benefit petitioner expected to receive in the year of payment, as were the barrelage payments;

(3) The fact that benefits derived from payment in one year extend beyond the year of payment is not determinative of the deductibility of such payment.

Although petitioner believes that it has made its

position on point (1) abundantly clear in its opening brief, nevertheless, at the risk of perhaps being repetitious, it is felt that a momentary reference to the factual situation behind the payments under the option should suffice to clarify the point in petitioner's favor. If we omit from consideration the accelerated payments made in 1942 to discharge obligations under the option which would otherwise have fallen upon petitioner during succeeding years, we find as an uncontroverted fact (Res. Br. 12) (Tr. 109) that petitioner's decision to exercise the option and to make fixed sum payments over a period of five years in the sum of $200,000 a year was motivated by consideration that royalty payments, if continued on a barrelage basis as in the preceding five years, would equal or exceed the fixed sum payments. Such payments were then, in their inception, and in a very real sense, just as much geared to estimated annual production for the period as were the barrelage payments.

As to the second point, the benefit which petitioner anticipated would accrue to it from each year's payment was expected to be measured closely by the amount of the payment. Such being the case, the payments were no different in character from those, fixed in amount, which a lessee normally pays for the use of leased property. It can hardly be controverted that rent for the use of property is, generally speaking, fixed according to market value and wholly without relation to the production of the tenant. The cases cited on this point by petitioner in its opening brief are merely a few of a large number which recog-

nize and accept fixed or lump sum payments without question. A fixed sum payment is as equally a consideration paid for the use of another's property as one determined in amount upon a percentage basis. Therefore, payments accrued by plaintiff under the option agreement in 1940 and 1941, while they differed from the previous payments in the method of determination of the dollar amount in each case, were not, by that one difference in any way rendered the less deductible.

A brief comparison of petitioner's situation on December 31, 1940, as compared with December 31 of any year between 1935 and 1940 further emphasizes the correctness of petitioner's position. In the former years petitioner would have accrued on that date an amount equivalent to the stipulated percentage of its production for the preceding six months. For the year 1940, instead of doing this, it accrued a flat sum of $100,000. Likewise at the end of 1941, it accrued the amount of its fixed obligation for that year, namely $200,000. By way of further illustration of this point, let us suppose that the original contract of 1935 had provided for renegotiation after a five-year period, rather than exercise of an option. Suppose in 1940, Rainier had told petitioner it might continue use of the trade name at a price of $200,000 a year thereafter for a period of five years at the end of which time some further adjustment might be made. At the end of that five-year period suppose a new contract was entered into for use of the trade name upon compliance with certain requirements, but without the requirement that any royalty pay-

ments be made. There could be little question that in such case the payments of $200,000 per year over the five-year period would have been deductible under Section 23 (a)(1). The mere change from a percentage basis to a fixed sum basis of payment would not operate to change the nature of the payments from a tax standpoint.

Respondent's attempt to differentiate the payments made prior to 1940 from those made thereafter on the ground that the original payments for the use of the trade name were made for the year of payment only and to secure benefits applicable to that year is not in accord with the original contract under which petitioner obtained a "perpetual" license, nor is it in accord with the actual economic effect of the barrelage payments. As the barrelage royalty payments continued to be made during the years from 1935 to 1940, the benefits to be derived from each year's payments were not strictly limited to the year in which the payment occurred. This is obvious from the schedule of sales (Pet. Ex. 15) showing a steady increase from year to year resulting in petitioner's estimate in 1940 that annual royalties on a barrelage basis would thereafter be somewhere in the neighborhood of $200,000 a year. Had Rainier first licensed use of the trade name to petitioner in 1939 instead of 1935, it can hardly be maintained that its value to petitioner would have been as great as it was as a result of petitioner's use of it over the previous several years. We must conclude, therefore, that at least some benefit was derived by petitioner in years following the year of payment from each annual

payment on a barrelage basis, and yet the Commissioner has not questioned the propriety of claiming those payments as deductions for the years in which they were made.

If a mere change in the amount of a deduction is insufficient to determine whether it is, in fact, deductible or not, then we may consider what, if anything, petitioner received in consideration of its payments or accruals in the taxable years in question which was sufficiently different from what it had received for annual payments prior to 1940 to constitute a change in tax treatment of such payments. This is answered by considering what would have happened to petitioner's rights to the use of the trade mark had it failed to make the payment of $200,000 required of it on July 1, 1941. The answer is obvious. Its rights under the original contract would have been subject to termination by Rainier just the same and to the same extent as if it had failed to pay the royalties due in any of the preceding years computed upon a barrelage basis. Payment of the first note upon its due date was as vital to the continuation of petitioner's rights to use Rainier's trade name as any payment would have been under the agreement prior to exercise of the option. Payment of the $200,000 made in 1941 was entirely exhausted during that time and the benefit derived therefrom did not extend beyond that year in which payment was made to any greater degree than did the benefits derived from any of the annual payments made in the years 1935 to 1940, which payments both the respondent and the Tax Court have agreed are properly deductible. At the

end of the period for which the payment was made in 1941 taxpayer had no greater assurance that it would enjoy the continued use of Rainier's trade name than it had in any of the preceding years with respect to which payments upon a barrelage basis had been made. Continued use and enjoyment of the trade name in 1942, for example, was wholly and entirely contingent upon the payment of the $200,000 which petitioner had obligated itself to pay in that year.

Had each note been paid upon its due date, that is, annually, for a period of five years, the same situation would have prevailed with respect to the notes due in each of these years. Failure to pay any one of them upon its due date would have resulted in petitioner's loss of the right to use the trade name. The fact that some of these notes were, subsequent to the taxable years here involved, paid off in advance, should not be given consideration in determining the nature of the payments made or accrued in the particular taxable years in question. In any case, the prepayment of the annual obligations would merely mean that petitioner could not take a deduction for the entire amount in the year of payment but should properly be allowed deductions allocated to the years over which the payments were originally expected to be made.

Payment of the note upon its due date was "required to be made as a condition to the continued use or possession, for purposes of the trade or business of property to which the taxpayer has not taken or is not taking title." Quoting as we have from the

exact language of Section 23 (a)(1) of the Code, we submit that such payment falls completely within the statutory language and that in so doing, its deductibility is established.

As to the third point, despite respondent's contention that as a condition to deductibility under Section 23 (a)(1), the payment must not result in benefit beyond the taxable year, we find any number of instances in the field of tax law where benefits do accrue beyond the taxable year from payments which are allowed as properly deductible expenses.

As previously pointed out, the use of the trade name by petitioner for one year and payment therefor would necessarily result in benefit to petitioner in future years. The fact that petitioner paid for the use of the trade name in one year, whether payment was on a barrelage or fixed sum basis, enabled petitioner to have the right to use the trade name in a subsequent year upon making payment for that year and to that degree provided a benefit extending beyond the year of the original payment. As we have attempted to show, this situation was no different after exercise of the option from what it was before, and it is no different, also, from a variety of situations which may be cited in which some benefit must of necessity extend beyond the taxable year, and yet the payment is allowed as a deduction in toto in the year in which made. Thus, the advertising expenses of a business in any one year redound to the benefit of the taxpayer in subsequent years and yet such expenditures are uniformly permitted as current deductions. Payments made for engineering services,

for executives' salaries and for salesmen's salaries, all contemplate benefits to the corporation paying them which will extend beyond the year in which payment is made and result in the building up of good will, expansion of the business, greater acceptability of the company's products, wider markets, and greater profits; the same is true in the case of leases of property. A uniform rental may be paid when in fact the benefit derived therefrom by the tenant might be much greater as the property is developed than it was in the earlier years of the lease. In support of his position respondent has quoted at length from 4 Mertens, Law of Federal Income Taxation, Sec. 25.17 (Res. Br. 22-23). Respondent might well have given a more complete picture of the situation by continuing his quotation, which reads (*Ibid.* Page 338-339):

> "The test of ultimate advantage or increase in value of the property is an unreliable guide. Assuming that the expenditure is ordinary and necessary in the operation of the taxpayer's business, the answer to the question as to whether the expenditure is an allowable deduction as a business expense must be determined from the nature of the expenditure itself, which in turn depends on the extent and permanency of the work accomplished by the expenditure."

Respondent's quotation, outlining the type of expenditure which is not deductible, has reference specifically to an expenditure made for the acquisition of an asset which has an economically useful life beyond the taxable year, yet it is this very "acquisition of a capital asset" which petitioner has consistently

maintained, did not occur either before or after the exercise of the option and respondent has conceded as much in admitting that no sale took place. How else could petitioner have acquired from Rainier an asset belonging to Rainier, except by purchase, gift or legal process?

The analogy between the usual expenditures for advertising and the accrual by petitioner of payments for 1940 and 1941 to Rainier for use of its trade name is striking. The Bureau of Internal Revenue has taken the position in these cases that advertising expenses are not to be treated as deferred charges, but are deductible as business expenses only during the year paid or incurred.

O.D. 1039, Cum. Bull. 1930 (1921);

Colonial Ice Cream Co., 7 B.T.A. 154 (1927);

F. E. Booth Co., 21 B.T.A. 148 (1930);

Richmond Hosiery Mills, 6 B.T.A. 1247 (1927) aff'd. C.C.A. 5, 1928) 29 F.(2d) 262, cert. den. 279 U.S. 844.

These cases have recognized that the expenditures involved may have represented substantial amounts classifiable as capital expenditures in the nature of deferred charges, as well as amounts of current expense and yet the whole amount is allowable as a deduction in the year of payment.

Likewise in the recent case of *Scruggs-Vandervoort-Barney, Inc.*, 7 T.C. No. 93, petitioner, a retail department store, decided to reimburse the depositors of a bank which went into receivership and which had been substantially owned by petitioner's prede-

cessor. It issued merchandise purchase certificates redeemable at its store to the bank's depositors for the amount of their losses and deducted the total amount on its income tax return as an ordinary and necessary business expense. The deduction was allowed, the court stating in part as follows:

> "We think that the facts in the instant case show that the expenditures in question were made to protect and promote petitioner's business and did not result in the acquisition of a capital asset."

Manifestly such an expenditure as this would result in benefit to the taxpayer in years subsequent to the one in which the deduction was claimed, to a greater extent, in fact, than could conceivably be the case with respect to the payments made or accrued during 1940 or 1941 by petitioner herein, inasmuch as any future benefit which could be derived from these payments was contingent upon petitioner's continuing to make the other payments for which it was obligated in subsequent years. In the case cited, however, the benefits to taxpayer by its expenditure would extend beyond the taxable year without any such contingencies being involved. Of similar import, though admittedly not in point upon their facts, are such cases as *Watkins Salt Co.*, 1 T.C. 125, where a lump sum compromise settlement of a claim alleged to be due from prior years was allowed in full as a deduction in the year in which paid; *Saks & Co.*, 20 B.T.A. 1151, where there was allowed as a deduction payment for legal services which might properly have been capitalized. The court recognizes, at page 1156, that the

benefits from legal advice are often not confined to the year in which given but because of the impracticability of segregating capital and expense items in such payments, the deduction was allowed. To the same effect is *First National Bank of Skowhegan, Maine,* 35 B.T.A. 876, in which the taxpayer made a payment to an out-of-town bank in consideration for the latter's taking over the assets and assuming the liabilities of a local bank about to be closed. The expenditure was made to protect petitioner's business and was allowed as an ordinary and necessary expense within the meaning of Section 23(a). Here again it is manifest that the consequences of such expenditure would inure to the benefit of the taxpayer well beyond the year in which the payment was made.

Petitioner therefore submits that the respondent is in error in taking the position that, if a payment made for the use of another's property results in a benefit to the one making the payment which extends beyond the taxable year in which the payment is made, no deduction for such payment can be allowed. Petitioner further submits that, even assuming the Commissioner to be right in this position, he is nevertheless in error in applying it to the payments made or accrued by petitioner in the taxable years 1940 and 1941, for the reason that no greater benefit in subsequent years accrued to petitioner as a result of such payments than accrued in prior years as a result of payments on the barrelage basis.

Several further points of lesser importance remain to be clarified with respect to respondent's brief.

Respondent, at page 23, refers briefly to the phrase "or in which he has no equity" contained in Sec. 23 (a)(1) and merely suggests that it is applicable adversely to petitioner's position. Lest this reference result in some confusion, petitioner submits that the following authorities establish that the meaning of the word "equity" as used therein is synonymous with equitable title. This is settled in the case of *Citizen's National Bank of Kirksville, Missouri*, 42 B.T.A. 539, aff'd. (C.C.A. 8) 122 F.(2d) 1011, cert. den. 315 U.S. 822, in the course of which opinion the court approved a definition of equitable title as a right possessed by a person to have the legal title to property transferred to him upon the performance of specified conditions. Other authorities to this effect include:

20 C.J. 1304;

16 Cyc. 90;

Des Moines Joint Stock Land Bank v. Allan (Iowa) 261 N.W. 912, at 917;

Austin v. American Surety Co. (Calif.) 4 P.(2d) 577;

Alexander W. Smith, Jr., 20 B.T.A. 27;

W. C. Cashin & Co. v. Alamac Hotel Co. (N.J.) 131 Atl. 117.

These cases treat and apply the term "equity" as synonymous with equitable title or equitable interest and as meaning a real beneficial interest or substantive right of the taxpayer in property to which the legal title is held by another.

See, to the same effect with respect to equity as meaning equitable title, *Steve Lodzieski v. Commis-*

sioner, Docket No 3060, Memorandum Decision entered October 6, 1944 (3 T.C.M. 1056).

In the cases where it is held that the taxpayer is "taking an equity," situations were involved where the taxpayer was, in fact, by its payments acquiring an equitable interest, although it had not ripened into legal title. In the instant case petitioner has acquired neither a legal nor an equitable title in the trade names for the use of which payments were made and by reason of the continuing obligations of the contract between Rainier and petitioner, petitioner had no expectancy of acquiring legal title in the future to the trade names. This was basic, as petitioner has pointed out in its opening brief, by reason of the fact that Rainier steadfastly refused to sell petitioner its trade name. Furthermore, respondent has conceded this point in admitting that no sale of a capital asset occurred.

Respondent has characterized petitioner's license as a combination of elimination of competition and the use of Rainier's good will and trade names (Resp. Br. 27). If respondent's reference to elimination of competition is intended to apply to any pre-existing manufacture of products by Rainier under the trade names in the territory involved herein, it is contrary to the evidence (Tr. 38-39, 116). With respect to elimination of sales competition, it must be borne in mind that the payments claimed as deductible were not, by the terms of the agreement, made in consideration of transfer of good will or elimination of competition, or anything other than the right to use the trade names. If restriction of competition

followed from the fact that the license was an exclusive one within a certain territory, it is simply as collateral and incident to the exercise of the license. And if these factors which respondent denominates a permanent asset accrued to petitioner through the payment of fixed compensation, it is equally true that they accrued as a result of payment of barrelage compensation. If they were acquired at all, they were acquired at the time of the original grant in 1935, for the entire rights which petitioner obtained arose out of the grant of the license under the agreement of that year.

Respondent makes a point at page 25 in its brief of the fact that there is no basis for amortization of any part of the lump sum payments to the taxable years and adverts to petitioner's admission on this point. Petitioner's position in this respect should be clearly understood. It takes the position that it did not acquire a capital asset from Rainier, and with this the respondent has substantially agreed by admitting that no sale occurred. Petitioner admits only that, had it acquired a capital asset by purchase from Rainier, then and then only would there be no basis for writing off the market value of such asset by amortization. Since, however, petitioner did not become the owner of a capital asset, the question of its right to amortize such is academic. It would have no right to amortize the cost of such an asset, even assuming a basis for doing so could be found, because it was not the owner thereof.

It is to be noted that respondent on page 18 of his brief assumes that petitioner has abandoned its al-

ternative claim to deductions on the basis of royalties which would have been paid on the old barrelage rate during 1940 and 1941. Petitioner has not abandoned this claim, but simply has not seen fit to raise and discuss it in its brief by reason of the fact that the Tax Court was not called upon to decide between various possible methods of determining the amount of the deduction, having decided that no deduction whatsoever was allowable. Petitioner maintains that it should be permitted to deduct as an accrual the annual payment of $200,000 as revised rental or royalty for the five-year period, or at least for the taxable years 1940 and 1941, the years involved herein; and if this is not deemed proper, then, secondly, that the payments or obligations should be treated as prepaid expense and deducted on such basis as would best properly reflect income and that under the evidence offered by the petitioner this would be a continuance of the barrelage rate (Tr. 126).

There remain to be considered, several cases which respondent has cited in support of his contentions. One is *Duffy v. Central Railroad*, 268 U.S. 55, cited at page 29 of respondent's brief as authority for the position that the lump sum payments made by petitioner were not, by reason of the other continuing obligations under petitioner's agreement with Rainier, failure to perform which would at all times have resulted in forfeiture of the license by petitioner, prevented from being capital investments. On its facts alone, that case presented a very different situation from the one involved here. Under the terms of the lease involved therein the taxpayer was required

to acquire and pay for the interest of private owners in an old pier and to construct a new one in its place. It sought to claim a deduction for the cost of performing this provision of the lease. Clearly such an expenditure resulted in the acquisition of new additions to the properties and the expenditure was exactly the sort of thing provided for under the depreciation sections of the statute involved. The court held that the expenditure was not a rental or other payment required to be made as a condition to the continued use or possession of the property, saying that that section of the statute did not include payments uncertain both as to amount and time made for the cost of improvements.

The case of *Welch v. Helvering*, 290 U.S. 111 (Resp. Br. 29), while concerned with the application of the same statutory language as that with which we are involved was decided with relation to a portion of that language with which we are not now concerned. That question involved whether or not the payments concerned were "ordinary" business expenses, with respect to which phrase respondent has raised no question in the instant case. The court determined that the payments involved were not ordinary but "in a high degree extraordinary" (290 U.S. 112, at 114). Indeed, the opinion in this case is worthy of consideration as upholding petitioner's position that it is not vital in determining the deductibility of a business expense under Section 23 (a) (1) that benefit therefrom be received and exhausted in the year of payment. The court points out that a law suit affecting the safety of business may happen once

in a lifetime and yet the expense is an ordinary one (page 114). Likewise, in the cases cited in the footnote at page 115 of the opinion, we find various instances where expenses have been allowed as deductions in one year and yet beyond question a benefit therefrom would accrue to the taxpayer in subsequent years as well as in the year of payment. The *Welch* case was cited, explained and distinguished in *First National Bank of Skowhegan, Maine*, 35 B.T.A. 876, at page 884.

CONCLUSION

From the foregoing, petitioner submits that the payments made by petitioner pursuant to exercise of the option come completely within the statutory language of Sec. 23 (a)(1), I.R.C., and should be allowed as deductions either at the rate of $200,000 per year for the taxable years in question, or by allocation of prepaid expense in accordance with the petitioner's established practice of accounting on the barrelage basis.

Respectfully,

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